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The Viability of Outsourcing in Organisational Performance: Benefits and Risks

Mário Franco, Margarida Rodrigues and Rui Silva

Abstract

Outsourcing is part of a system, as it includes products and services integrated in a value chain and which are performed by an external (contracted) firm, aiming to establish an interdependent, collaborative and trusting relationship between the contracting and contracted firms. Like any dimension of business in organisations, changes in organisational structures and in how the service is produced/provided, outsourcing brings benefits and risks. Therefore, from literature review method, this chapter aims to explore the concept of outsourcing as a differentiating tool in organisations' performance, emphasising the benefits and risks. The results showed the dimensions to consider in the decision to implement outsourcing, which are: (1) transaction costs, (2) use of resources, and (3) collaboration between the parties. The contribution of the study is to present a synopsis of the outsourcing topic, specifically the theories that support it, its benefits and risks. Additionally, a decision-making model is presented, in the certainty of its usefulness for the organizations' managers.

Keywords: Outsourcing, organisational performance, theories, strategic decision

1. Introduction

The concept of outsourcing dates back to the 1940s (Second World War) and emerged in the United States of America (USA), given the war industry's need to concentrate on improving arms production in order to maintain the Allies' supremacy. This industry passed on some activities supporting production to other firms providing services [1]. However, only in the second half of the 20th century was the concept put into practice in the service sector, to stimulate organisations' profitability through sub-contracting services. These services cover low-value activities, such as cleaning and security, and others such as marketing, human resources, information technology and finance.

Here, Nunes [2] argued that outsourcing is a way to add value to business. In other words, outsourcing is a strategy to improve organisations' efficiency, through contracting specialised third parties to carry out some organisational functions [3]. Jacobs et al. [4] and Quélin and Duhamel [5] defined outsourcing as an operational change, involving transfers of suppliers. Barrett and Baldry [6] explained it is a process in which the user contracts a supplier to perform one of the organisation's internal functions and transfers assets (human resources and management responsibility) to this end.

Nevertheless, outsourcing is regularly confused with sub-contracting, given the close relationship, but the main strategic function of outsourcing is to ensure an organisation's profitability, through control of the financial area, human resources and information and technology, allowing efficiency and effective management of the available organisational resources by resorting to external sources to perform a certain area of business. This way of making organisations profitable has gained relevance, as an organisational tool, as a consequence of the opportunities and threats caused by globalisation.

Outsourcing allows the construction of better business, stronger economies and a more prosperous life-style [7]. Access to information, allied to technological innovation, lets organisations decide and act in a global scenario, creating interdependence and stimulating productivity and competitiveness, as argued by the same author. However, adopting it involves a decision, specifically one of the main decisions faced by organisations being the question of producing a given product/service or acquiring it through external entities - "make or buy" - where the focus is on gaining a competitive advantage over rivals [7, 8]. Therefore, outsourcing emerges as a strategic tool claiming to respond to current issues in the global economy [9], a real way to obtain a competitive advantage [10] and is an innovation in the service category, allied to the dynamics of core competences [11]. Recently, Ramasubbu et al. [12] concluded that the early studies on information systems controls considered only the projects developed internally by the organisations, currently, these go through external subcontracting, i.e., outsourcing, which include face-to-face and virtual teams, characterised by flexibility and agility.

Despite the growing number of organisations using outsourcing, not all achieve the expected results. So there must be a strategic focus to overcome the associated risks, since the success of any organisation is the fruit of its strategic orientation [13–15].

Regarding the theoretical framework, various theories support studies on the risks and benefits of outsourcing in industries and service providers. However, *"some of them are complementary, the others are contradictory. This creates confusion among the researchers of the outsourcing phenomenon"* ([8], p. 1). The following theories are highlighted: Transaction Cost Theory [16], Resource-Based View Theory [17] and Relational View Theory [18]. These theories and others will be addressed in the next sections dealing with the topics raised, because according to Perunović [8], this concept should be approached holistically.

In the vast literature on this topic, some gaps remain, which justifies this study. For example, research has been carried out on governance mechanisms [19] or explicitly relational mechanisms [20], but numerous studies have a limited reach due to using proof based on case studies [21] or on secondary data [22]. More recently, Hanafizadeh and Zararavasan [23] stated that more studies were necessary on the factors affecting decisions to use outsourcing. Moreover, in order to facilitate perception of organisational strategic processes, various researchers [24–27] studied the factors contributing to organisations choosing outsourcing. Also the decision between Insourcing and Outsourcing ("make or buy") has contributed to research aiming to understand the benefits and risks involved in that decision [28].

According to the dominant line of thought in the literature, in terms of organisational management, outsourcing can be considered a strategic tool that when correctly implemented allows a reduction in costs [29, 30] and optimised production [31], potentially giving organisations a competitive advantage [10, 32]. Therefore, this chapter aims to explore the concept of outsourcing as a differentiating tool in organisations' performance, to determine the viability of implementing this strategic tool, through the constructs of the benefits and risks associated with

the process of deciding between *make* and *buy*. This means that this chapter aims to present a synopsis of the outsourcing topic, specifically the theories that support it, its benefits and risks. Additionally, a decision-making model is presented, in the certainty of its usefulness for the organizations' managers.

2. Literature review

2.1 Brief synopsis

Organisations have been sub-contracting since the Industrial Revolution [3]. The managers of pioneering projects using outsourcing have left strong lessons: the importance of following an appropriate process in selecting suppliers and drawing up the contract; the importance of reaching an appropriate balance between the costs and benefits, understanding how the benefits can arise; the need for both parties to allocate their own resources to manage the relation and for new models to encourage both, and individual and organisational rewards in seeking success [33]; also showing that failure is always associated with responsibility [3].

Focused on the USA and the UK, the belief emerged that improved results were obtained based on solutions originating in competitive markets, such as the private sector [34]. For these authors, the focus was on reducing costs and better use of organisations' available resources, which in the public sector would imply a change in administrative processes, with hierarchical structures giving way to more flexible organisational structures, with growing concern about customers' needs, similarly to what happens in the private sector.

With outsourcing being a strategic tool, the decision to implement it should involve analysis of the set of levels forming an organisation, in tacit, strategic and operational terms [7]. This author also highlights that at a first level, corresponding to tacit relations, outsourcing was seen as a tool to solve organisational problems (lack of administrative competence, inappropriateness of human resources or lack of financial resources), where it was important to obtain better services involving less capital investment and less management time. Subsequently, outsourcing evolved to the strategic level, with maturing relationships, moving from a tacit tool to a management tool. Relations changed from seller and buyer to the formation of partnerships. External functions took on greater control in terms of responsibility, by directing attention to the strategic aspect. For Corbett [7], strategic outsourcing redefined organisations' essential competences, through forming long-term contracts and creating relations with suppliers, directed towards results. The last level concerns operational outsourcing, allowing managers to redefine the business. Value is found in the innovations that external sources can add to the organisation. It is also described as tool of leverage, allowing business changes in order to fit the global market, new customers and the need to introduce new products and/or services to the market [35]. According to Corbett [7], service providers are no longer seen only as means to obtain more efficient business, to be regarded as partners. As mentioned by Elmuti et al. [36], when an organisation opts for outsourcing to stimulate business, it should make a detailed strategic analysis to determine the benefits that can arise.

Elfring and Baven [37] identified the variables that can influence the choice of make or buy, in three groups: (1) strategic factors, including questions related to the main business, advantages and the specified quality; (2) environmental factors, which reflect the speed of technological development, exponential competitiveness in the supplier market and government regulations; and (3) operational factors, which are production costs and scale economy. To understand the emerging market,

Pitelis and Teece [38] suggested adding to these items the aspect of external coordination and learning.

2.2 Theoretical framework

Various theoretical streams in the economic sector address topics intrinsic to outsourcing, such as organisational cooperation and strategic planning. Studies on these theories absorbed theoretical aspects related to the benefits and risks arising from outsourcing. These approaches were summarised by Perunović [8] and are shown in Table 1.

The theories highlighted for the purpose of this study are: Transaction Cost Theory, Resource-Based View and Relational View Theory. Based on the theories explained above, there is literature that supports the outsourcing of companies [54, 55], whose decision is based on the need to boost economic efficiency, focus on strategy and greater business flexibility [56, 57].

2.3 Benefits of outsourcing

Theoretical study regarding the benefits of outsourcing relates to Transaction Cost Theory, created by Coase [58] and developed, many years later, by Williamson [59, 60].

For Coase [58], transaction costs are the results of the attempt to obtain market information, as the author assumes this process is intrinsic to each organisation, as well as negotiating and signing contracts, including in this case the costs associated with monitoring the clauses agreed. However, the most suitable concept was used by Arrow [61], in which transaction costs are seen as the costs related to the administrative aspect of the economic system.

Analysis of transaction costs can determine the best type of relation an organisation should adopt with respect to its market of operation. Therefore, the central focus of this theory is the costs associated with each transaction made by the organisation with the aim of obtaining profit. In the decision to adopt outsourcing, the organisation should consider transaction (operational and contractual) costs as well as internal (production) costs. If internal costs are greater than transaction costs, outsourcing will be the most viable solution for the organisation [62].

Theory	Author(s)
Transaction Cost Economics (TCE)	Brandes et al. [39]; Vining and Globerman [40]; Arnold [41]; Aubert et al. [42]; Barthélemy and Geyer [43]; Miranda and Kim [44]; Gottschalk and Solli-Saether [18]; Sahay, Halldórsson and Skjott-Larsen (2006) [45]; Barthélemy and Quélin [46]
Resource-Based View	Roy and Aubert [47]; Barthélemy and Geyer [43]; Gottschalk and Solli-Saether [18]; Barthélemy and Quélin [46]
Relational View	Willcocks and Choi [48]; Baden-Fuller and Hunt [49]; Barthélemy [50]; Gottschalk and Solli-Saether [51]; Sahay, Halldórsson & Skjott-Larsen [45]
Core Competences	Willcocks and Choi [48]; Brandes et al. [39]; Gottschalk and Solli-Saether [18]; Sahay, Halldórsson and Skjott-Larsen [45], Desai [52]
Agency Theory	Gottschalk and Solli-Saether [51]
Social-Exchange Theory	Whitten and Wakefield [53]; Sahay, Halldórsson and Skjott-Larsen [45]

Source: Adapted from Perunović [8].

Table 1.
Theories used in research on the outsourcing process.

This theory suggests the option with the best cost–benefit ratio as being one of the decisive factors in the organisation's decision-making process. When an organisation's internal production presents excessive investment in obtaining the lowest unitary cost, it should turn to outsourcing. This argument was argued by Rockwell [63], when postulate that outsourcing helps organisations to minimise the cost of projects and save money.

However, as Transaction Cost Theory focuses above all on the organisation's relation with the market in terms of costs, this was subject to criticism by some researchers. According to some authors, this theory ignored the role of differentiating capacities in the structuring of the organisational economy [64], neglecting power relations [65], trust and other forms of social insertion [66], as well as evolutionary considerations such as Knightian uncertainty and market processes. Transaction Cost Theory gave way to Resource-Based Theory.

Resource-Based Theory, proposed by Barney [67], considers the resources present in an organisation as a means to achieve its profitability and strategic advantage. The idea is based on the organisation holding a set of resources that can support its competitive advantage and lasting strategic performance. This theory highlights organisational resources and capacities as a source of competitive advantage [67].

With an identical theoretical reasoning to Resource-Based Theory is Knowledge-Based Theory [68], seen as an evolution of the former. Besides being studied based on the resources it holds, the organisation can also structure new resources efficiently. Here, organisational knowledge is seen as a factor stimulating performance in its functions, and can also be considered as a resource based on its characteristics and capacities. Therefore, both theories contribute to improving organisational performance, by stimulating competitive advantage, studying the capacity to manage the resources and knowledge available internally. When the necessary competences are lacking, an organisation should resort to outsourcing.

Managers have been increasingly perceiving that outsourcing allows them to accept more demanding contracts, since they have more capable human resources for this purpose, as they can access global resources [63]. In addition to the access to an increased range of resources, Berson [69] determined the reasons for firms implementing outsourcing, to increase their competitive advantage, these being: a) reduction and control of operational costs; b) management's focus on essential activities; c) access to quality, global resources; d) freeing up internal resources for other purposes; e) obtaining resources that are not available internally. Bowers [70] also identified the basis for implementing outsourcing: the quality of services, which should be greater if obtained outside the organisation; cost reduction; diminishing the number of problems to be dealt with internally by the organisation (reducing the level of management complexity); access to knowledge about new technology; reduced expenditure on training (cost advantage); the use of global infrastructure; unlimited access to resources; access to better technical resources; guaranteed level of service; greater simplicity in daily operations (reducing the level of management complexity).

Finally, Relational View Theory, inspired by Cook [71] and based on the Resource-Based View of Barney [67], highlights the advantages of inter-organisational exchanges through forming collaborative relations such as franchising, strategic alliances or joint-ventures. This theory proposes that the more intense the relational exchange with partners, the more financial benefits can arise [72]. Implementation of these inter-organisational relations allows increased tacit knowledge, contributing to the organisation's differentiation and consequently obtaining a competitive advantage. So outsourcing is seen as a flexible strategic tool, for increased response capacity and resource management, in order to respond to the present day's technological and innovation needs. Besides access to the

organisation's internal and specialised capacities, this tool goes towards obtaining new resources, through reducing the need for capital.

2.4 Risks of outsourcing

Although the idea of risk is broad and varies according to the area of knowledge studied, some authors seek to present a definition. For Kaplan and Garrick [73], risk is defined as a trilet (si, pi, ci), in which "si" represents the scenario, "pi" refers to the probability of that scenario occurring and "ci" involves its consequences. In this way, risk can be seen as the doubt about the seriousness of the consequences of a given activity or the result of the combination of the consequence and the associated uncertainty [74].

In Transaction Cost Theory, Williamson [59] considered that in any transaction there are elements that hinder its fulfilment, such as limited rationality, opportunism, the low number of negotiations and packaged information. Also in the presence of high asset specificity, uncertainty and low frequency, a careful analysis should be made, to avoid underestimating the total cost of the transaction, as this can be increased instead of the desired reduction [62].

In study of the risks involved in outsourcing, Agency Theory [75] is also highlighted. In this theory, two parties in the cooperative relation are involved in an association in which one of them, the "principal", delegates tasks and decisions to the "agent". Here, consideration must be given to factors such as the potential existence of a conflict of interests between the principal and the agent, the fact of each acting according to their interests, the existence of information gaps between the parties, the possibility of the principal being more prone to risk-taking than the agent and the principal's difficulty in monitoring the agent effectively and efficiently.

Given the similarities between Transaction Cost Theory and Agency Theory regarding the associated risks, four major risks related to outsourcing can be highlighted. The first is the principal's difficulty in leaving the relation without incurring losses and/or sacrifices in favour of the agent. The need to make changes to the contract can also be seen as a risk. There is also the risk of financial investment in resolving conflicts and risks associated with financial underestimation of transaction costs.

Relational View Theory, similarly to the benefits, is also related to the risks associated with outsourcing. As explained in Transaction Cost Theory, among the factors highlighted in terms of difficulty is opportunism which can enter the relations established, making it difficult for the parties involved to obtain a win-win relation [76]. Therefore, Relational View Theory explains how firms achieve and hold on to competitive advantage within inter-organisational relations [77]. Its key premise - the concept of relational rents - explains how firms choose their future externalisation partners and the preferred type of relation, which has an underlying risk [8].

One way of lessening the risks is approaching them through performance to select what should be subject to outsourcing, and this is divided in three dimensions [78]. The first is related to the strategic question associated with assessing the importance of owning or having good access to the process being examined. The second is related to the operational question, which seeks to define the levels of performance of the services to be outsourced and the levels currently achieved by the firm that will carry this out, avoiding unattainable expectations. The third dimension reflects the organisational dimension, in which the connection between the specific strategy of the processes and the business strategy is assessed [78].

From another perspective, Barthélemy and Quélin [46] studied the negative results of implementing outsourcing. These authors examined 82 cases of implementation of outsourcing in Europe and the United States, describing seven fatal errors in outsourcing, which are: outsourcing activities that should not be in that category; wrong selection of the seller; a weak contract; aspects neglecting staff; loss of control over outsourced activities; neglecting the hidden costs of outsourcing; lack of planning of an exit strategy. The same authors argue that when the outsourcing strategy is well defined, there is a positive association with organisational performance.

In short, the decision on the use of outsourcing should take into account the associated risks, without neglecting that this strategic option aims at maximising benefits for organisations, specifically efficiency, profitability, organisational performance, sustainability, cost reduction and optimisation of available resources [79].

3. Proposal of a theoretical framework

The above sections explained that organisations opting to outsource some of their functions should formulate and plan a strategy that balances the benefits and the risks. Therefore, a theoretical model is proposed aiming to help the decision-making process about the viability of outsourcing, without putting organisational performance at risk.

The flowchart in **Figure 1** systematises an effective way to optimise the decision to place a firm's organisational functions in an outsourcing system. It also shows the

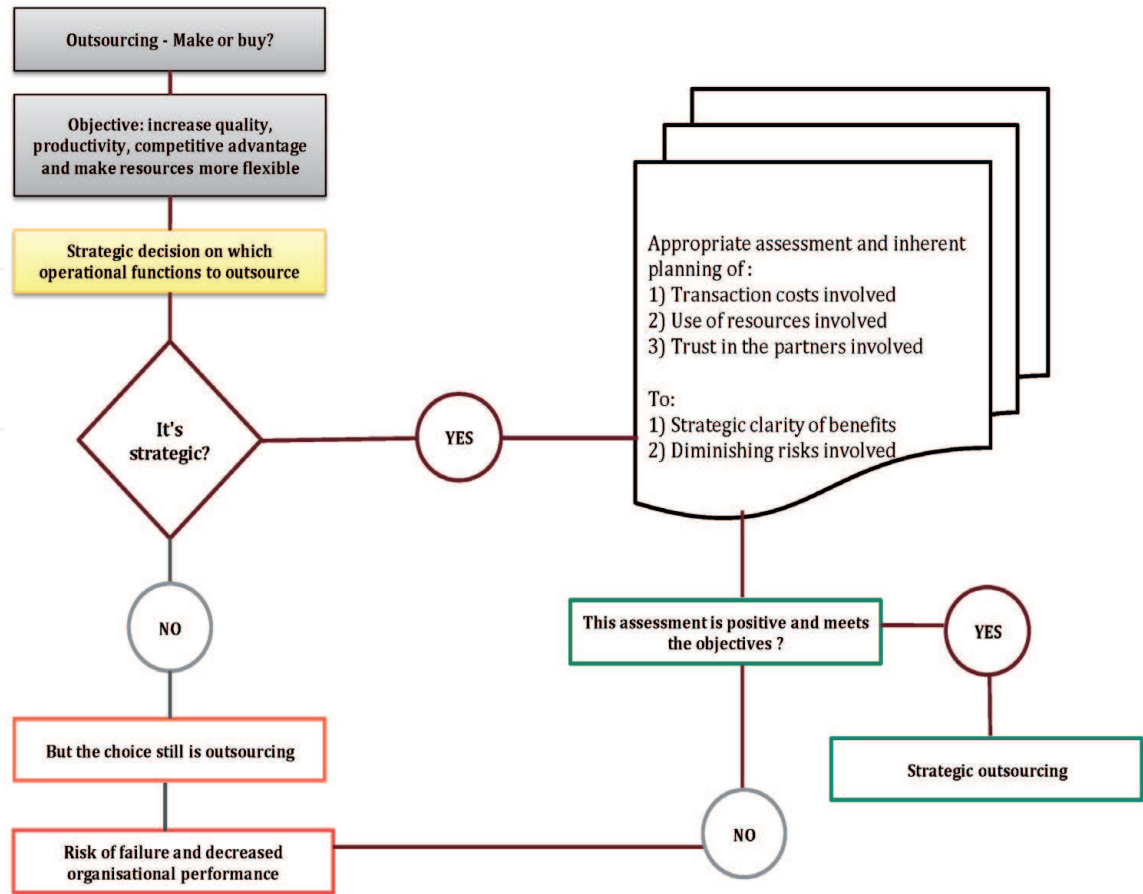


Figure 1.
Theoretical model.

importance of this being a strategic decision, considering the risks and benefits, as well as transaction costs, resources and the typology and characteristics of partners. If this planning is effective, it allows correct determination of all the constructs included in the decision with positive impacts on quality, competitive advantage and maximisation of organisational performance. This means that *“the outsourcing decision not only impinges on the operational procedures of firms, but also affects claims against organisations and their future net cash flows”* ([80], p. 11).

This postulation is in line with the literature reviewed in the previous sections, given that we are talking about a decision of a strategic nature [9, 13, 30, 56, 79], which should be supported by an organisational policy of reducing current and future costs [29, 34, 62, 63], of an efficient allocation of available resources (internal and external) [7, 33, 63, 70]. No less important for the success of this externalisation is the improvement in the competitiveness of the organisations, provided that the determinants mentioned by Berson [69] are guaranteed.

In addition, this model uses as theoretical framework, the theory of transaction costs (cost reduction), the resource-based theory (efficient allocation of resources) and the Relational View Theory (efficient and effective partner relationships).

4. Final considerations

Outsourcing is beginning to be common practice in organisations, focusing on the softest organisational structures and in this way significantly reducing fixed structural costs, whether in production, service provision or human capital. However, choosing this instrument involves risks and uncertainties, since it involves transaction costs between the parties, important matters related to resources and assets, and efficient, trusting relations between the contracting and contracted firms. It is therefore essential to make a detailed analysis of these risks in parallel with the benefits arising from this type of partnership.

The literature presented here showed the importance of considering this strategic choice - outsourcing -, always bearing in mind that maximisation of organisational performance is a consequence of increased quality, productivity and competitive advantage in relation to rivals. If this is not taken into consideration, organisations that resort to outsourcing face the challenge of surviving in the global market, as they can enter a spiral of negative effects due to not having planned their decision strategically.

As with any study, this one is not without limitations. Firstly, the fact of being a descriptive study, and so it will be important in the future to make a systematic literature review through a bibliometric analysis, resorting to RStudio, for example. The second concerns the theories used, as many support outsourcing (e.g., knowledge-based theory, social-exchange theory, core competences theory).

Although not a recent topic in the literature, it will be interesting in the future to carry out empirical studies of the negative and positive effects of outsourcing on the organisational performance of those contracting. Study of why contracted entities fail is also suggested.

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